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# Economic Conditions
# Governmental Finance
# United States Securities



New York, June, 1942

## General Business Conditions

TWO developments of the past month — the establishment of general price ceilings effective May 11 and 18, and issuance of the first consumer ration cards ever required in this country — carry the war effort into a new phase. Until a few weeks ago most of the wartime economic controls applied primarily to the industries. The distributive trades were relatively free, except for the automobile dealers and other special cases; and interferences with the every-day lives of individuals, apart from those entering the armed services, were mostly indirect. Even the higher taxes and higher living costs were felt only by a minority, since to great groups of the population the war effort has brought increased income.

The new moves, however, spread the controls from the industries to merchants and consumers. Prices charged by distributors as well as manufacturers have been brought under regulation, and the War Production Board is considering limitation of the stocks of goods which merchants can carry. Consumers' purchases of sugar over the country, and gasoline in the East, have been limited by rationing. Price Administrator Henderson has stated that eventual rationing of a total of some fifteen commodities is under consideration. The War Manpower Commission has announced that it will "freeze" war workers in their present jobs.

Undoubtedly government controls in the months to come will affect people directly much more than heretofore. The inroads of war needs upon civilian goods and services in many respects are only beginning. Moreover, the decision to establish general price ceilings made it certain that other controls would spread, for when prices are frozen the function of guiding production and consumption, which is the normal function of price changes, must be performed by other means. If supply and demand are not to be balanced by fluctuating prices they naturally will have to be balanced by the decisions and regulations of the overhead authority, telling people what they can make and buy. In cases of scarcity rationing becomes a necessary adjunct of price ceilings, not only to conserve supplies and distribute commodities equitably, but to repress abnormal demand and keep the ceilings effective in the face of rising purchasing power.

### Inroads on Civilian Production

How greatly the supply of consumer goods will shrink, and when and how widely direct limitation of consumer buying may be resorted to, are of course subject to developments. Inventories now on hand will augment supplies currently produced, and will defer many prospective scarcities for months to come; and ingenuity and resourcefulness may stave off other shortages. The situation in different lines will vary widely. But all industrial reports emphasize — along with the speed of conversion to war work and the record-breaking armament output — the inroads upon production for civilian use. Reliable estimates indicate that production of consumers' durable goods in April (excluding housing) was only one-third the volume of a year earlier, although total industrial production was 20 per cent higher.

During the next two months more industries producing durable goods will shut down, making their plants — or if their plants cannot be used, their labor — available for war work. The order of the W.P.B. prohibiting the use of iron or steel in the manufacture of over 400 articles, which will put an end to many civilian products, becomes effective August 3, and the list may be extended. Also, war needs for many goods of everyday use, for example leather and rayon, are running ahead of earlier estimates. The pressure upon shipping and other transportation affects all industries and consumers; irrespective of production, shipping tie-ups make it impossible to have accustomed goods at all times in all places.

In certain industries the opinion is held that the Government is taking more of the output for war uses than it will need, and that in due course there will be a greater release into civilian channels. But however correct this

may be, the Government necessarily has full priority and is receiving loyal cooperation and support. The country realizes that the men who have been most nearly correct about war requirements have been those who set their figures highest, and that far too much is at stake to permit any compromise with an all-out program.

Even if government demand for certain types of goods eases before the end of the war is in sight, it does not follow that production of those goods for civilians will represent the best use for the labor and transportation released. They may be needed elsewhere in the war effort. An additional 10,500,000 workers will be required in war industries by the end of this year and 7,500,000 during 1943, according to the Chairman of the War Manpower Commission, Mr. McNutt. They will come of course from the unemployed, from youths growing up to working age, from women in the homes, but most of all, at least during 1942, from converted and curtailed civilian industries.

Nothing has been more effective in lifting the spirit of the country than the production accomplishment, and nothing will support that spirit as well as people's knowledge that if they must get along with less, it is because the war industries and the armed services are using more. Arms plants now in production are exceeding schedules in many cases by wide margins, due to labor and management efficiency and to widespread and spectacular improvements in manufacturing technology. As their efficiency rises they make greater calls for materials and transportation. This is behind the decision of the War Production Board to cut down the number of new plants hereafter to be constructed; the armament job can be done in fewer plants than formerly proposed, and use of materials to produce arms now rather than in the future will do more to win the war.

### The Overall Price Ceilings

The overall price ceilings have been received by manufacturers and distributors with every evidence of desire to cooperate in making the ceilings work. Markups in prices established between the high point in March and May 18 of course have been canceled, and the further markups which merchants expected to make on the basis of rising replacement costs have to be foregone. It was to be expected that there would be petitions to the Office of Price Administration for relief where the prices fixed were out of line with costs; and if the relief cannot be had, unprofitable items will tend to disappear from merchants' shelves. Responsible department store officials have said that in the textile and apparel lines which constitute up to 75 per cent of department and variety store merchandise the ceiling prices will run as much as 10 to 15 per cent below replacement costs. This is a measure of the "squeeze" which the retailers would like to have rolled back to wholesalers and manufacturers, who in turn would like to roll back the squeeze on their own margins.

Mr. Henderson has reiterated that the retail ceilings cannot be punctured. He has told merchants that they must consider it their duty to absorb losses in lines which do not make up a substantial part of their business, or to pass them on to their suppliers; and that they are expected not to apply for relief except in unusual circumstances. Likewise, there is little suggestion of relief for the squeeze on manufacturers. In fixing ceilings on Fall clothing lines, which were not dealt in during the March base period, the O.P.A. is giving scant consideration to the wage increases which took effect in the clothing trades early in May, or to the earlier increases in woolen goods prices. Fall lines of women's clothing must be priced no higher than the highest price on similar lines sold between July 1 and September 30, 1941. Presumably this precedent will be followed in setting prices on men's lines. The O.P.A. admitted the increased costs, but pointed out that from 5 to 15 per cent of the yardage in each garment can be saved by simplifying styles according to specifications previously issued.

How disruptive the squeezing of margins may be on distributors generally can only be guessed, for much will depend upon further decisions of the O.P.A. with respect to roll backs, and upon future trends of distributing costs. The pressures will compel distributors to restudy their costs; and whatever they may do, certain factors will work against them. Their volume will be reduced and their overhead costs therefore higher. In some lines distributors as well as manufacturers will have to meet special costs inevitable under war conditions, such as abnormal transportation charges and higher labor costs resulting from employment of less efficient or more expensive workers, which is to be expected as demands on the labor supply increase.

### Subsidies To Offset the "Squeeze"

In some cases, and under conditions still to be defined, the O.P.A. has disclosed that it expects to pay subsidies where the squeeze of the price ceilings or future cost increases is insupportable. Since an appropriation of funds from Congress will be required if the payments are to reach any large sum, it may be some time before a subsidy plan is formulated in detail. The Senate Banking and Currency Committee included, in a bill increasing the borrowing power of the Reconstruction Finance Corporation by $5 billions, authority for the Corporation to pay subsidies. However, the amendment was withdrawn, on the Senate floor, for further study.

Subsidy provisions, to prevent increased costs of raw material from being rolled forward to the consumer, are included in the Canadian price control measure, upon which ours is modeled. It is evident, however, that where subsidies are paid they increase the government debt, put added purchasing power in the hands of the people who receive them, and thus add to the inflationary forces which the price order is designed to control. Whether the burden is in higher prices or subsidies, eventually it falls upon the people. The difference is that higher prices are borne by those who consume the goods, while subsidies spread the increased costs over the economic system as a whole. It may be argued with some reason that it is more desirable to place part or all of certain wartime costs, such as the added cost of railway transportation of petroleum and coal to places formerly served by ships, upon the whole economy rather than the people affected. On the other hand, a system of subsidies opens the gates to abuses, to political pressures, and to maintenance of inefficiency.

**The Principles of Price Control**

Not all economists believed in the desirability, even under war conditions, of overall price ceilings. Many would have preferred to deal with the inflationary danger by other means—by more drastic taxation in the lower income brackets where the greater part of the demand for consumer goods arises; possibly by compulsory savings; by control of selected prices only, and chiefly at the raw material or first processing stage; and by a flexible policy of discouraging wage increases and keeping costs down rather than by wage-freezing. They argued that restraint on the price *level* was feasible by such means, but that control of *individual* prices on an overall basis was impracticable and dangerous. The argument runs that prices are only symptoms of underlying economic relationships, and that if they are not free to fluctuate when underlying relationships change unbearable strains are thrown upon producers and distributors which may react upon the effectiveness of the war effort.

Furthermore, they desired to preserve the incentive that high relative prices, for goods where needs are greatest, give to increase output. They believed that the economic organization would function at its highest efficiency if it were accorded the largest possible measure of freedom, subject of course to the diversion of productive effort to the war program. For similar reasons they did not favor a hard and fast freezing of wages.

These arguments take account of the fact that economic relations are naturally flexible and that every attempt to freeze them sets up complex problems. Every economist and business man will recognize that price and wage changes constitute in ordinary times the most practicable and desirable way of guiding productive effort and distributing the labor supply among the industries. Already noted are the disturbing effects of price freezing on both the industries and distributive trades, the inequities and grave administrative difficulties, and the problems that will pile up as costs and trade conditions change.

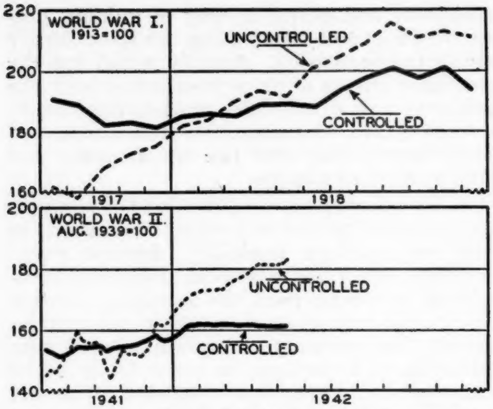
On the other hand, the difficulties of attempting to control prices and wages piecemeal, in order to maintain flexibility, present equal problems. Experience showed that each control led to others, until the selective controls in fact appeared to be merging into a general control. The assent of each group of producers and workers to ceilings is more likely to be whole-hearted when all are treated according to a uniform principle; and this is an important consideration in the practical politics as well as the economics of the question.

**Requirements to Make the Ceilings Work**

Now that the decision in favor of general price ceilings has been taken, it is entitled to whole-hearted support. Some of the points made above are still being voiced, repeated now as special pleas for the exemption of wages and farm prices from the ceilings. But once the price system has been given up as the guide and stimulus to production the ground is cut from beneath arguments for exceptions. The problem now is not to determine a policy, but to understand all the implications and requirements of the policy decided on, and to make it work.

It may be suggested that at least four essential requirements must be observed if blanket price controls are to work effectively. The first is that the number of exceptions to the general price order should be held at the lowest practicable minimum, for the obvious reason that one man's prices are another's costs. In many cases prices of exempted goods may continue to rise, and if so the rises will exert pressure upon the controlled prices. An important criticism of the general price order is that, according to an O.P.A. calculation, items making up one-third of retail grocery sales are exempt. This leaves the way open to further rises in living costs. In the last war and in this war prices left uncontrolled have risen. The chart on the next page shows in the upper part the course of prices of 573 controlled and 793 uncontrolled commodities during the last war, as represented by indexes given in the volume "Government Control Over Prices," published in 1920 by the War Industries Board. The uncontrolled prices rose and they pulled controlled prices with them, although the latter moved more slowly.

The record of price controls so far in this war is of course confined to basic commodities. The lower part of the chart gives the course of twenty controlled and eight uncontrolled basic




**Prices of Controlled and Uncontrolled Commodities**

commodities, which are those included in the daily index of 28 commodities published by the Bureau of Labor Statistics. The controlled commodities include the following: zinc, copper, lead, scrap steel (two markets), hides, print cloth, raw silk, rubber, sugar, tin, burlap, coffee, cocoa beans, tallow, lard, shellac, rosin, cottonseed oil, and wool tops; the uncontrolled commodities are: wheat, flaxseed, barley, corn, butter, hogs, steers, and cotton. The controls were put into effect at various times, two in 1940, most during 1941, and in the case of eight commodities not until after Pearl Harbor. Since Pearl Harbor the lines have diverged markedly, suggesting a repetition of the experience of the last war.

These charts illustrate the danger of the exceptions to the blanket order. If leeway is left for inflationary influences they will find places where they can break out, and if prices move at one place they set up strains at others.

### Influence of Costs

The second and related requirement to make the ceilings work is that if prices are to be controlled costs should be controlled. In last analysis 65 to 70 per cent of the cost of finished goods is represented by wages, including the labor cost of the materials used in the goods; and it is evident that general increases in these costs would develop pressure upon the controlled prices. This is the danger of exempting wages from the general freezing.

No one has stated oftener than Mr. Henderson the fact that it is impracticable to stabilize prices without stabilizing costs. To be sure, it may be unnecessary to stabilize wages by law if they can be stabilized in fact by other means. Actually, however, the proposals for wage stabilization are still regrettably without clear definition or directive. Principles have been stated, but the application moves slowly. Shipbuilding workers received increases in wages, but less than they were entitled to under their contract; this may be interpreted as contributing to stabilization, or the contrary, according to the point of view. President Roosevelt stated in a press conference that an airplane company which desires and is able to raise wages should not do so because of the effect it would have on other wages in the surrounding territory, where employers might not be able to meet the resulting competition for the labor supply. This statement touched directly upon the way in which wage increases imperil the anti-inflationary program; they spread to employers who cannot absorb them and thus become reflected in prices.

The chairman of the War Labor Board, Mr. Davis, has said in a public address that "both labor and management will have to show the greatest of self-restraint on the wage front," and has indicated a belief that wage increases should be forbidden, for workers getting more than $25 a week, without government approval. On the other hand, he repels suggestions of wage-freezing. Union leaders continue to ask increases, and denounce proposals for freezing. Critical cases are now coming before the War Labor Board, including the application of the unions for $1 a day increase in the "Little Steel" companies, the General Motors Corporation and others. The decisions in these cases may be considered as the next critical development in the effort to control inflation.

### The Place of Taxes

It would hardly be sufficient to stabilize wage rates at present high levels without steps to absorb some of the buying power that is now flowing from these wages. Thus the third requirement to make the price ceilings work is that, as the supply of goods for civilian use diminishes, more of the swollen buying power which has forced prices up should be diverted from the markets. It is one thing to divert this stream of purchasing power by taxes and savings, but a far greater problem to allow it to flow in full force and try to escape its effects on prices by interposing a dam of artificial price ceilings. Prices measure demand as well as supply, and the function of anti-inflationary taxation is to reduce demand at the place where the demand is effective.

It goes without saying that the price ceilings will not work unless they are faithfully observed by seller and buyer alike, and unless every citizen sets an example for every other. This is the fourth requirement. Control of individual action by overhead authority is by nature an inferior substitute for what people can do for themselves. The more individual policies accord with the needs of the war effort and the objectives of the Government, the less the Government will have to do and the better it will be done.

Some may say that not every exception will upset the whole price structure, and that the

best that can be expected is to slow down the rise in prices and keep it within moderate proportions. Actually this may be true. But the dangers in accepting anything less than a total program are that ineffectiveness in any quarter will set up strains elsewhere, and that signs of ineffectiveness may be interpreted as indications of impending breakdown and lead, through the human desire of people to fare as well as their neighbors, to a spread of violations and disregard of the regulation.

To summarize, the omission from the blanket ceilings of some important prices and of wages, and the fact that they have not yet been supported by adequate anti-inflationary taxation, constitute their weakness as the chief reliance in combating inflation. In fact, there can be no safe reliance on any single measure, but only on an integrated policy, all parts of which support every other part. President Roosevelt made this clear in his message on April 27 when he said: "No single step would be adequate by itself. Action in one direction alone would be offset by inaction in other directions. Only an all-embracing program will suffice."

## Progress of the Tax Bill

The House Committee on Ways and Means, by the end of its third month of work on the new tax bill, has tentatively settled a majority of the important questions in connection with changes in corporate and individual taxes.

Decisions of major interest announced to date by the committee with respect to individual income taxes include the lowering of personal exemptions of single persons from $750 to $500, and of married couples from $1,500 to $1,200; raising the normal tax rate from 4% to 6%; and raising the schedule of surtax rates to begin at 12% instead of 6%, and reach 81% for incomes over $200,000. It was voted to retain the present credit for dependents and for earned income, but to require joint returns from married couples. A proposed "examination fee" of perhaps $5 on every return filed was rejected.

With respect to capital gains, the committee liberalized certain provisions of the tax as to offsetting capital losses against capital gains and against current income, but tightened other provisions and raised the effective rate of tax from 15% to 25%. The committee lowered exemptions on estate and gift taxes but rejected the Treasury's recommendation for increasing rates from the present schedule ranging up to 77% for estate taxes.

On corporation taxes, the committee raised the combined normal tax and surtax from 31% to 40%; lifted the excess profits tax from a maximum of 60% to 94%; but retained the option of computing excess profits on the basis of either average earnings or invested capital. It retained the capital stock tax (though shifting to an annual declaration), also the "declared value excess profits tax," and the 27½% depletion allowance for oil and gas companies.

### Broadening the Tax Base

In the lowering of personal income tax exemptions, raising the normal tax by one-half and doubling the rate at which the surtax begins, the committee has broadened the tax base by reaching further down into income groups which receive a large share of total national income and have been the chief beneficiaries of the increase in employment and payrolls since the start of the defense program.

It is estimated that the lowering of exemptions will increase from approximately 13 to 20 millions the number of persons filing taxable returns, though the amount of additional revenue to be derived from these new taxpayers would be relatively small — only about $100 millions out of $1.1 billion. The change in exemptions and in rates will be most effective in reaching new sources of revenue and purchasing power by exacting heavier contributions from the 9 millions or so of new taxpayers added to the Treasury lists by the Revenue Acts of 1940 and 1941. Even so it is probable that the bulk of the added revenue will come from the intermediate and upper brackets.

From the point of view of avoiding inflation, these proposals do not make any appreciable dent in the mass purchasing power now being tremendously increased by the outpouring of Treasury funds. What is needed to prevent inflation is the recapture of a major part of this increased income, which can only be achieved by either a much more drastic application of the income tax or by supplementing this tax by a tax of wide coverage, such as a general sales tax or a gross income tax deducted at the source.

How far the regular income tax alone — even with the proposed exemptions and rates — falls short of meeting the inflation threat caused by the swelling industrial payrolls is shown by the following table indicating for the lower income groups the percentage of tax after exemptions and other allowable deductions:

**Percentage of Combined Federal Normal Tax and Surtax to Individual Incomes of Various Sizes under the Proposed Exemptions and Rates***

| Income Before Exemptions | Single Person | Married, No Dependents | Married, One Dependent | Married, Two Dependents | Married, Three Dependents |
|---|---|---|---|---|---|
| $ 500...... | 0 | 0 | 0 | 0 | 0 |
| 1,000...... | 6.7 | 0 | 0 | 0 | 0 |
| 1,500...... | 9.6 | 1.3 | 0 | 0 | 0 |
| 2,000...... | 11.2 | 4.8 | 1.3 | 0 | 0 |
| 2,500...... | 12.0 | 7.0 | 4.1 | 1.3 | 0 |
| 3,000...... | 12.8 | 8.4 | 6.0 | 3.7 | 1.3 |
| 3,500..... | 13.6 | 9.5 | 7.4 | 5.4 | 3.3 |

*Figures computed on assumptions that all income is "earned income" entitled to 10% credit for normal tax, and that allowable deductions for interest, taxes, contributions, etc., amount to 10% of gross income.

The proposed increase in surtax rates, especially on the upper incomes, together with the requirement for joint returns and the heavier taxation of gifts and estates, are primarily taxes upon savings. Since savings under war conditions have practically no place to go but into government securities, the Government would get a large part of this money anyway; hence such taxes, while bringing in additional amounts of revenue, have little anti-inflationary effect.

On the other hand, the Treasury proposal that 10% of income be withheld at the source is timely and important as an anti-inflationary measure, since it would begin to operate immediately and would withdraw funds from consumer purchasing power before they would be spent.

### The Corporate Tax Proposals

The committee plan to raise the combined corporate normal and surtax from 31% to 40% and the excess profits tax from 60% to 94%, contrasting with Treasury proposals for a combined normal and surtax of 55% and excess profits rates ranging up to 75%, is in accord with the principle that war taxes should be levied mainly against abnormal profits rather than against normal earnings.

The proposed increase, however, in the excess profits rate to such a high figure as 94% carries serious danger to the effective operation of the country's economic machinery. Many concerns now engaged in war production in volume several times their best peacetime records are finding that taxes already are decreasing their cash and forcing an increase in their indebtedness, with consequent decrease in liquidity. The numerous dividend reductions now being announced reflect this condition, as well as the downturn in earnings now being experienced as a result of increased taxes, rising costs and conversion to war work.

Concerns doing an outstanding job in war production, making possible a lowering of contract prices to the Government, are finding themselves on a par with less efficient and higher cost producers in that any reward in the form of increased profit resulting from good management and invention is practically all taxed away. Similarly, concerns which have reduced debt, either through plowing back earnings or converting bonds into stock, are now heavily penalized as tax credits for interest paid are reduced while net income subject to the high normal and excess profits tax is increased.

Moreover, with an excess profits tax of nearly 100% making utterly impossible the accumulation of adequate reserves, business men who have had to expand their operations many fold, with all that implies in the way of increased plant, equipment and commitments of all sorts, as well as borrowings from the banks and the R.F.C., are wondering what is going to happen to them when the war is over. They remember that after the last war there were widespread cancellations of contracts, defaults on accounts and notes receivable, and heavy losses on inventories. Many of our large and well-known industrial companies whose amazing expansion of production helped to win the war found themselves far worse off financially at the end than at the beginning, while bankruptcies and reorganizations were numerous. This was because so much of the "profits" made (on the books) during the war, upon which high taxes were paid out in cash, was represented by business assets whose value largely disappeared almost overnight.

In testifying before the committee last month, Mr. Colin M. Stam, head of the legislative staff of tax experts, reviewed the unfavorable effects of excessively high taxes in this country during the last war and in England during the present war. He expressed the opinion that it was impossible from a practical standpoint to tax the entire war profits, pointing out that some allowance must be made for a margin of error in determining taxable income, that such income is not always in the form of money or liquid assets, and that under a too high excess profits tax there would be no tendency to hold down costs to a reasonable basis. The statement ended with the observation that unless some incentive were granted in the form of a post-war credit, it was believed that a 94% rate would seriously hamper the war effort, stimulate inefficiency and tend toward inflation.

A strong statement of the repressive effects of such taxation upon initiative and enterprise was made by the Hon. C. Fraser Elliott, Canadian Commissioner of Taxation, in a recent public address:

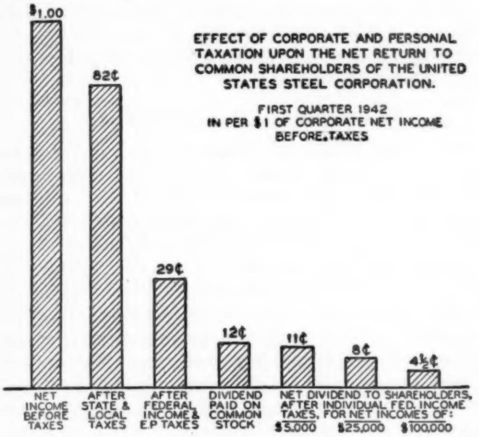
> A deadline for profits in the form of 100% tax in a capitalistic system is the frustration of its basic principles, and the destroyer of hope, for without hope, even though hope take the form of an after-the-war partial refund, industry wanes.

One effect of raising tax rates too high is to increase greatly the incentive for tax avoidance. In a statement to the Ways and Means Committee on May 28, Secretary Morgenthau cited a number of instances described as "particularly unpardonable attempts to escape taxation" by payments of excessive salaries and bonuses, or by other devices to inflate expenses. Such practices, although exceptional, tend to reflect upon the entire business community and are deplored by the majority of business men, and means must be found to deal with them. It is well to recognize, however, that very high rates tend to encourage evasion of this kind or even to stifle the enterprise so taxed.

### Taxes and the Return to Shareholders

The effect of present corporate and individual income taxes upon the net return to sharehold-

ers is illustrated in the accompanying chart showing the distribution of net income of the United States Steel Corporation in the first quarter of 1942. This company has been selected because of its size and prominence, and the fact that all of the essential details were given in its earnings statement for the latest quarter, but the trends shown indicate what is happening — in varying degree — to corporations generally.




Taking for the first quarter of this year $1.00 of income available to the common stock, after operating expenses, reserves and preferred dividends but before any taxes, the remainder after payment or accrual of state, local and miscellaneous taxes was approximately 82¢. After allowance for estimated liability on federal income and excess profits taxes, the reported net income was reduced to 29¢. Even these tax reserves set up in April may prove to be inadequate in view of the committee proposal for still higher excess profits rates.

The quarterly dividend declared on the common stock amounted to but 12¢ out of the original $1.00 of income before taxes, the remaining net income being retained by the corporation for investment in inventories and facilities required for its constantly expanding production of steel products, ships and other materials going almost exclusively into the war program.

When the 12¢ of dividend was received by the common shareholders of the company, numbering 163,732 at the beginning of the year, it was again subject to tax. For a shareholder having $5,000 net income from all sources, taking the proposed normal and surtax schedules for a married man with two dependents, the net dividend after payment of individual federal income tax would be 11¢. For a shareholder with $25,000 net income, the net dividend would be 8¢, and for a shareholder with $100,000 net income, the net dividend would be but 4½¢. If the shareholder were subject also to a state income tax, the balance remaining would be further reduced.

Taxes have now driven down almost to the vanishing point the net dividend yield to many large shareholders, despite the fact that their investments may be in lines of business which involve extraordinary risk because of wide cyclical fluctuations. For a holder of U. S. Steel common having $100,000 of net income from all sources, his net dividend after taxes represents an annual rate of return of only about 1¼% on the book value of his stock.

By contrast, while the shareholders who supplied the equity capital for the Corporation's vast investment in plant, equipment and current assets received the same gross dividends as last year, and smaller net dividends after personal income taxes, the total payroll was 31% larger. Average compensation per employee rose from an annual rate of $1,800 in the first quarter of 1941 to $2,025 in the first quarter of this year. Such income, if received by a married man with two dependents, would under the committee proposal pay no income tax, because of exemptions and allowable credits, as indicated in the table above.

### The Power to Destroy

The unprecedented sums required by the Government at this time leave no question as to need for heavy taxes on all available sources of income. But in times of war taxes after all are second to production, and the tax burden must be so distributed as not to impair the country's productive processes.

In years past when the general level of taxes was relatively low, the precise rates and provisions were matters of comparative unimportance. As taxes have steadily risen, they have borne with increasing severity upon the upper incomes and the corporate enterprises, partly because of theoretical reasons — "capacity to pay," "need for distributing wealth," etc. — but very largely also because of plain politics and the fact that such money is relatively "easy to get." The result has been a tax system bearing primarily upon savings and the economic machinery that is responsible for production and that has made possible our high standard of living. The power to tax is the power to destroy, and at the high tax rates now current there must be careful watch lest, without recognizing it, we be led along this trail far beyond the point of diminishing returns and even to the point of destructiveness.

## The Mounting Problem of the Deficit

Publication by the Budget Bureau late in April of revised budget estimates for the current and next fiscal year affords new evidence both of the rapidly rising tempo of war production and of the enormous financing problem facing the country.

When the President presented budget estimates in January forecasting war expenditures

this fiscal year at $24 billions and next year at nearly $53 billions, many persons thought the figures far too high. Yet actually in less than four months they were raised still higher, and according to the revised budget figures war expenditures are now expected to reach $26 billions for this fiscal year and $67 billions for 1943, not including loans by government corporations for war purposes at $2 billions for 1942 and $3 billions for 1943.

Revenue estimates, too, were revised upwards, but not so much as were the expenditure estimates. The result has been to increase still further the expected deficits, now placed at nearly $20 billions for fiscal '42 and nearly $50 billions for fiscal '43, notwithstanding allowance in the latter year for $7 billions of new taxes. The preceding table, summarizing the latest budget totals against a background of earlier years, illustrates more effectively than words the staggering dimensions of these figures.

Despite an expected rise in revenues to more than three times the largest total of any year prior to 1941, contemplated borrowings for 1943 alone are nearly twice the total borrowings of World War I.

**United States Government Receipts and Expenditures, 1914-1943**
(In Millions of Dollars)

| Year Ended June 30 | Total Net Receipts | Net Expenditures: National Defense | Net Expenditures: All Other | Net Expenditures: Net Total | Net Surplus or Deficit |
|---|---|---|---|---|---|
| 1914........ | $ 735 | $ 263 | $ 472 | $ 735 | $ .... |
| 1915........ | 698 | 268 | 493 | 761 | —63 |
| 1916........ | 783 | 286 | 448 | 734 | +48 |
| 1917........ | 1,124 | 1,452 | 526 | 1,978 | — 853 |
| 1918........ | 3,665 | 10,838 | 1,859 | 12,697 | — 9,033 |
| 1919........ | 5,152 | 14,444 | 4,071 | 18,515 | —13,363 |
| 1920........ | 6,995 | 2,718 | 3,685 | 6,403 | + 292 |
| 1921........ | 5,625 | 1,767 | 3,349 | 5,116 | + 509 |
| 1922........ | 4,109 | 888 | 2,485 | 3,373 | + 736 |
| 1923........ | 4,007 | 675 | 2,620 | 3,295 | + 712 |
| 1924........ | 4,012 | 603 | 2,446 | 3,049 | + 963 |
| 1925........ | 3,780 | 626 | 2,437 | 3,063 | + 717 |
| 1926........ | 3,963 | 599 | 2,499 | 3,098 | + 865 |
| 1927........ | 4,129 | 614 | 2,360 | 2,974 | + 1,155 |
| 1928........ | 4,042 | 643 | 2,460 | 3,103 | + 939 |
| 1929........ | 4,033 | 698 | 2,601 | 3,299 | + 734 |
| 1930........ | 4,178 | 721 | 2,719 | 3,440 | + 738 |
| 1931........ | 3,190 | 667 | 3,004 | 3,671 | — 481 |
| 1932........ | 2,006 | 664 | 3,871 | 4,535 | — 2,529 |
| 1933........ | 2,080 | 651 | 3,213 | 3,864 | — 1,784 |
| 1934........ | 3,116 | 578 | 5,433 | 6,011 | — 2,895 |
| 1935........ | 3,800 | 726 | 6,284 | 7,010 | — 3,210 |
| 1936........ | 4,116 | 940 | 7,726 | 8,666 | — 4,550 |
| 1937........ | 5,029 | 967 | 7,210 | 8,177 | — 3,148 |
| 1938........ | 5,855 | 1,066 | 6,173 | 7,239 | — 1,384 |
| 1939........ | 5,165 | 1,251 | 7,456 | 8,707 | — 3,542 |
| 1940........ | 5,387 | 1,711 | 7,287 | 8,998 | — 3,611 |
| 1941........ | 7,607 | 6,301 | 6,409 | 12,710 | — 5,103 |
| 1942†...... | 12,707 | 26,000 | 6,579 | 32,579 | —19,872 |
| 1943‡...... | 23,918 | 67,000 | 6,141 | 73,141 | —49,223 |

**United States Government Public Debt, 1914-1943**
(In Millions of Dollars)

| June 30 | Total | June 30 | Total | June 30 | Total |
|---|---|---|---|---|---|
| 1914........ | $ 1,188 | 1924........ | $21,251 | 1934........ | $27,053 |
| 1915........ | 1,191 | 1925........ | 20,516 | 1935........ | 28,701 |
| 1916........ | 1,225 | 1926........ | 19,643 | 1936........ | 33,778 |
| 1917........ | 2,976 | 1927........ | 18,510 | 1937........ | 36,425 |
| 1918........ | 12,244 | 1928........ | 17,604 | 1938........ | 37,165 |
| 1919........ | 25,482 | 1929........ | 16,931 | 1939........ | 40,440 |
| 1920........ | 24,298 | 1930........ | 16,185 | 1940........ | 42,968 |
| 1921........ | 23,976 | 1931........ | 16,801 | 1941........ | 48,961 |
| 1922........ | 22,964 | 1932........ | 19,487 | 1942†...... | 71,852 |
| 1923........ | 22,350 | 1933........ | 22,539 | 1943‡...... | 125,443 |

**Source:** Compiled from President's Budget Messages and Annual Reports of the Secretary of the Treasury. Expenditures exclude net appropriations to old-age insurance trust funds, while corresponding social security taxes are excluded from net receipts. Expenditures exclude sinking fund for debt retirement, and net outlays of government agencies. National defense total excludes expenditures charged to War Department for rivers and harbors, and flood control; also for Panama Canal; but include loans to foreign governments in 1917-21 and lease-lend in 1941-43. † Revised budget estimate. ‡Budget estimate, giving effect to $7 billions proposed new taxes. Public debt figures show direct debt only, and exclude guaranteed debt of government credit agencies.

### The Principles That Must Govern

That the sums to cover these huge deficits can and will be raised, there is of course not the slightest question. With all the modern facilities for creating purchasing power, who can doubt that in the extreme exigencies of war nations will find means one way or another of supplying the government with whatever money is needed to carry on the war? The real question is not, will the government get the money? It is, rather, *how* will it get the money? Upon the answer to this question will depend in large measure our ability to avoid grave currency and credit disorders, disruptive of the war effort and vastly complicating the problem of post-war recovery.

The answer to the question, how the war should be financed, has been given again and again, but cannot be stated too often, for consciousness of the urgent needs of the situation must be brought home to all the people if effective action is to be taken. First, of course, the maximum possible amounts should be raised by taxation. But since it is not possible, practically, to cover the entire cost by taxes, resort must be had to borrowing.

Such borrowing must be—to the largest extent possible—from savings, and especially saving from current income that would otherwise be spent. Where the greatest danger lies is in the financing of huge governmental deficits through expansion of bank credit, or worse still through creation of fiat money. Either injects great amounts of new purchasing power into the economy at a time when civilian goods are becoming scarcer and scarcer, thus creating a well-nigh irresistible force for inflation, with all its demoralizing immediate effects and calamitous aftermath.

On the other hand, if people save their money and buy bonds, spending by the public is cut down in proportion as spending by the government is increased, and inflation is avoided.

Next best to borrowing from current savings is borrowing from past savings in the form of idle balances in the hands of individuals and corporations. While the mopping up of such idle pools of savings is not as anti-inflationary

as the borrowing from current savings, and even exerts a certain inflationary influence in putting idle money to work, it nevertheless avoids the injection of new purchasing power into the system and is preferable to bank borrowing on that account.

In short, the principles that must govern the financing of deficits are: first and most important, borrowing from current savings, which will reduce current consumption; second, borrowing from past savings in the form of idle balances, which will still further reduce dependence upon the banks; and, third, reliance upon the commercial banks only for such remainder of the financing as cannot be taken care of out of savings. To the extent that methods one and two can be pursued with vigor, reducing the dependence upon three, by so much will the worst evils of deficit financing be minimized.

### The Record to Date

So much for the theory of war financing. What of the actual record to date?

Significant information on this score has been presented recently by the Economic Policy Commission of the American Bankers Association in a report entitled "Treasury War Borrowing and the Banks."

Basic material in this report appeared in Table I showing actual and indicated public financing by the Treasury for the fiscal years 1941-43, based on January 1942 budget estimates; Table II, actual and indicated sources of funds for Treasury public issues during the same period; and Table V, in that report, the effect of actual and indicated Treasury borrowing from the banks upon bank total loans and investments, deposits, and capital ratios.

Following are reproductions of these tables, adjusted to give effect to the revised budget estimates of April 24 and other changes suggested by latest available data:

TABLE I

**Receipts — Expenditures — Public Financing**

(In Millions of Dollars)

| | Fiscal 1941 Actual | Fiscal 1942 Revised Budget | Fiscal 1943 Revised Budget |
|---|---|---|---|
| Total Expenditures (excluding debt retirement) | 12,711 | 32,576 | 73,141 |
| Total Net Receipts (excluding social security) | 7,607 | 12,707 | 23,918* |
| Budget Deficit | 5,103 | 19,872 | 49,223 |
| Add. govt. corp.—net outlays | 1,149 | 2,220 | 2,941 |
| Total cash requirements | 6,252 | 22,092 | 52,164 |
| Less trust funds receipts—net | 1,385 | 2,018 | 4,764† |
| Net cash requirements | 4,867 | 20,074 | 47,400 |
| Change in Cash Balance | + 708 | —15 | —3 |
| Total Public Financing | 5,575 | 20,059 | 47,397 |

* Includes proposed new taxes of $7 billions.
† Includes proposed new social security taxes of $2 billions.

TABLE II

**Estimated Changes in Holdings of Publicly Held Direct and Guaranteed Debt Based on Continuance of Recent Trends**

(In Millions of Dollars)

| | Fiscal 1941 Actual | Fiscal 1942 Estimated | Fiscal 1943 Projected |
|---|---|---|---|
| War savings bonds | +1,409 | + 6,000 | +12,000* |
| Tax anticipation notes | ...... | + 2,700 | + 1,000 |
| Insurance companies | + 600 | + 2,000 | + 1,500 |
| Mutual savings banks | + 312 | + 300 | + 300 |
| Other (excl. commercial banks) | — 300 | + 2,500 | + 3,000 |
| Subtotal | +2,021 | +13,500 | +17,800 |
| Commercial Banks | +3,554 | + 6,500 | +29,600 |
| Total | +5,575 | +20,000 | +47,400 |

* Assumes: war savings bond sales at rate of $1 billion a month, the Treasury's objective.

TABLE V

**Effect of Government Security Purchases On All Member Banks, Assuming Purchases as Indicated in Table II**

(In Billions of Dollars)

| | June 30, 1941 | June 30, 1942 | June 30, 1943 |
|---|---|---|---|
| **Total Loans & Investments:** | | | |
| Loans | 16.7 | 18.0 | 18.0 |
| Governments | 18.1 | 23.6 | 48.8 |
| Other Investments | 5.8 | 6.0 | 6.0 |
| Total | 40.6 | 47.6 | 72.8 |
| **Liabilities:** | | | |
| Deposits | 58.5 | 64.9* | 87.9* |
| Capital Funds | 5.8 | 6.0 | 6.2 |
| **Capital Funds Ratios:** | | | |
| To Deposits | 9.9% | 9.2% | 7.0% |
| To Loans and Investments | 14.3% | 12.6% | 8.5% |

* Allows for currency increase calculated at annual rate indicated for country shown in May 6 bank statement, reduced by 15% to apply to member banks.

It will be seen from Table II that, on the basis of present trends (but assuming realization of the Treasury goal of selling $12 billions of war savings bonds in 1943), commercial banks will be called upon to absorb nearly $30 billions of government securities in 1943, following $6½ billions in 1942. This would be more than half the total increase in the publicly held debt over the two years, and as indicated in Table V would considerably more than double bank holdings of government securities during the period.

That increases of such magnitude would have important implications for the banking system and the general economy will be readily appreciated. They would mean increased exposure of bank portfolios to security market fluctuations. Bank deposits would be vastly expanded — according to Table V by something like 50 per cent on a two-year period — thus, together with increased currency, adding hugely to the volume of purchasing power at a time when the control of prices is becoming increasingly a problem. With bank loans and investments and deposits outstripping growth of capital funds, bank capital ratios would be substantially reduced.

### The Task Re-Appraised

The foregoing facts and figures, carrying only to June 30, 1943, demonstrate the need for a re-appraisal of the whole financing program with the idea of making it more adequate for the tremendous job to be done. There is need, first of all, for the elimination of every dollar of unnecessary government expenditure. In a program calculated to stretch the resources of the country to the utmost there is no place for waste, extravagence or indulgence of special groups or theories; the best way to begin tackling the problem of inflation is to cut government costs wherever it can be done without harmful results to the war effort.

There is need, secondly, for raising every possible dollar by taxation consistent with maintenance of necessary morale and production, bearing in mind that not only the amount but also the kinds of taxes are important, e.g., to be effective in preventing inflation taxes must reduce consumption.

There is need, thirdly, for canvassing more thoroughly the possibilities of non-banking lenders.

As to the last, the Treasury has been steadily increasing the scope and variety of its efforts to broaden the distribution of its securities. It has stepped up its weekly offerings of bills by $100 millions to $250 millions, and has reintroduced the certificate of indebtedness as a form of financing with a view to increasing the supply of highly liquid, short-term paper suitable for use not only by banks in adjusting their reserve position but also for investment by corporations having temporarily idle balances. The Treasury is constantly expanding and perfecting its nationwide organization for the sale of war savings bonds, and has an ever-increasing number of wage earners purchasing such bonds through regular payroll deductions. It has recently raised from $50,000 to $100,000 the maximum limit for purchases of the Series F and G savings bonds in any calendar year in order to increase the volume of sales to the larger individual, corporate and trust investors. Last month it offered a new type of long-term bond, not available to banks but directed rather to long-term investing institutions such as insurance companies; this was an issue of unspecified amount on which the books were held open for several days and was heavily subscribed, with sales approximating $880 millions. In its open-market financing the Treasury to an increasing extent is enlisting the aid not only of the commercial banks but of the established security marketing machinery of investment underwriters, distributors and brokers.

The announcement in the New York district of a Victory Fund Committee under the leadership of the President of the Federal Reserve Bank is an indication that the financial community is joining in a program for the more vigorous prosecution of sales of Treasury securities to the public. This parallels action in other districts and is clearly what must be done in every community throughout the country, with renewed energy and widened scope.

### Experience of the Last War

In attempting to appraise the financing job ahead, it should be instructive to recall what happened in the last war. While then, as now, the policy was to place as much as possible of the financing outside the commercial banks, the methods pursued were altogether different. Whereas now the main effort to reach non-banking subscribers is being centered in a continuous drive to sell war savings bonds, which are non-negotiable and cannot be used as collateral for borrowing at banks, in the last war the main effort was in the successive Liberty Loan campaigns and investors were freely encouraged to "borrow and buy".

That the country did a remarkable job in the Liberty Loan campaigns is shown by the figures. The First Liberty Loan was bought by over 4 million individual subscribers, the Second by over 9 millions, the Third by over 18 millions, and the Fourth by 23 millions which, as has been pointed out by Robert Warren of the Institute for Advanced Study at Princeton, was close to the number of families in the country. The following table shows the proportion of World War I debt placed with the banks and with the non-banking public:

**Summary of Gross Debt by Principal Holders. Three Years Ended June 30, 1919**
(In Millions of Dollars)

| | June 30, 1916 | June 30, 1919 | Change |
|---|---|---|---|
| Total gross debt | 1,225 | 25,484 | +24,259 |
| **Principal Holders** | | | |
| Federal Reserve Banks | 57 | 292 | + 235 |
| All commercial banks | 753 | 5,143 | + 4,390 |
| Non-banking public | 415 | 20,049 | +19,634 |

It will be seen that out of a gross debt increase of around $24,200 millions, the non-banking public took $19,600 millions, or 81 per cent, and the banks (including the Federal Reserve) $4,625 millions, or 19 per cent.

Comparing these figures of the last war with the figures of publicly financed debt during this year, as shown in Table II above, it will be noted that *commercial bank* takings amounted to 64 per cent of the total in fiscal 1941. Such takings will apparently be about 30 per cent in '42 (the drop in the ratio being due wholly to speeding up of non-banking absorption, as bank actual takings almost doubled); but in fiscal '43, with the enormous expansion of aggregate financing, will again be above 60 per cent if the trends shown in the table persist. Altogether, for the three years 1941-43, the indicated bank absorption works out at about 46 per cent for the non-banking public and 54 per cent for the banks.

In comparing the two war periods, allowance must be made of course for that portion of the

debt increase in 1917-19 financed indirectly by the banks in the form of loans to individual subscribers under "borrow and buy" arrangements. Just what this amounted to is not clear from the figures; while on June 30, 1919 the total of loans secured by Liberty Bond collateral was in the neighborhood of $2 billions, it does not necessarily follow that these were all loans to finance Liberty Bond subscriptions. However, even if they were it would still leave the proportion of World War debt increase financed by the non-banking public at around 73 per cent, and by the banks around 27 per cent.

The example of what was done in the last war to reach non-banking funds gives much encouragement as to what, with redoubled effort, can be done in this. The task, to be sure, is much greater; in the last war not over a quarter of the national income was devoted to war in any one year, as against the prospect of well over half in fiscal '43. We are collecting more from the people during this war in taxes, particularly in the middle and upper income brackets, which leaves less to be subscribed to loans, and reduces the net yield on bonds. And finally, interest rates are much lower, making more difficult the widespread placing of securities with individual investors.

The latter point is strikingly illustrated by the following table:

**Comparison of Gross Yield, and of Net Yield after Individual Income Taxes, of Treasury Bonds in 1918 and in 1942**

| | | Net yield after taxes for brackets of: | |
|---|---|---|---|
| **Issue** | **Rate** | **$15,000** | **$25,000** |
| 4th Liberty Loan, 1918 | 4¼% | 3.99% | 3.78% |
| Treasury saving bond or "tap" issue, 1942 ........ | 2½% | 1.60% | 1.30% |

Taxes are computed at rates of the top bracket, as would apply to additional income.

Of course, these rates relate themselves to the general market, and the rates obtainable on other investments. Even with this qualification, however, it is evident that the financial incentive for investment has been much reduced.

## Money and Banking

Excess reserves of the member banks continued to work lower during May, and at the close of the month were reported only little above $2½ billions for the System and $500 millions for banks in New York City. Both are low figures since 1938.

The downward trend reflects the steadily mounting currency and credit requirements of the war program. Both "money in circulation" and deposits of weekly reporting member banks reached new all-time high levels within the month. As banks purchase government securities, deposits expand, requiring more reserve, and hence reduce excess reserves.

The prospect of further huge takings of government securities by the banks, described in the preceding article, now dominates the money market outlook. With any such increase in deposits as suggested by these figures, excess reserves will become exhausted unless steps are taken by the authorities to maintain them at an adequate level. This can be done either through Reserve Bank purchases of government securities in the open market or through a lowering of reserve requirements, or a combination of both.

Action along these lines is confidently expected. Already since the early part of April the Reserve Banks have purchased approximately $250 millions net of government securities, thereby adding an equal amount to member bank reserves, which of course would sustain a credit volume several times as much. Included in the Reserve Banks purchases was $156 millions in Treasury bills, on which the Reserve Banks announced in April their readiness to purchase all offerings at ⅜ of 1 per cent. This action assures the banks a means of adjusting their reserve position and adds funds to the market.

### The Daily Treasury Statement

In these times the dominating part played by the Government's finances in the economic situation makes the daily statement of the United States Treasury of more than ordinary interest and value. It is no exaggeration to say that this statement makes a prompter and more complete disclosure of government financial operations than is the case in any other country in the world. Published excerpts from the statement necessarily present but a small part of the wealth of detailed information given.

The following extremely condensed summary of parts of the statement for May 26 shows, for example, that income tax collections this fiscal year are twice as large as a year ago; war expenditures are four times as large, and in its turn the sale of war savings bonds has also increased four-fold. It is interesting that redemptions of savings bonds are a smaller percentage of current sales than was true a year ago.

**Summary of U. S. Government Finances to May 26, 1942**

(In Millions of Dollars)

| | This Month | Corr. Period Last Year | Fiscal Yr. 1942 | Corr. Period Fisc. Yr. 1941 |
|---|---|---|---|---|
| Total revenue receipts | $ 486 | $333 | $10,281 | $6,270 |
| Income tax | 184 | 55 | 5,842 | 2,545 |
| Misc. internal revenue | 244 | 221 | 3,528 | 2,668 |
| Expenditures | 3,401 | 986 | 27,406 | 11,073 |
| War activities | 3,045 | 727 | 21,628 | 5,339 |
| Lend-lease | 511 | 5 | 3,297 | 5 |
| Other | 356 | 259 | 5,788 | 5,734 |
| War savings bonds | | | | |
| Sales | 540 | 302 | 5,339 | 1,164 |
| Redemptions | 19 | 12 | 182 | 131 |

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